initiatives transform the telecommunications industry, reviews of existing regulatory standards and mechanisms serve to prune away obstacles to greater competition.

Critical, too, are the issues raised in this review--"foster[ing] the development of substantial competition for interstate access services" (Notice, para. 149). The Notice sets out two alternative approaches to this goal--the so-called "market-based" and "prescriptive" approaches. The former provides for increasing degrees of pricing flexibility within the LEC price cap, each phase triggered by certain competitive criteria. The "prescriptive" approach would require initial pricing in closer accordance to cost as viable competition emerges. Given this focus, a better term for the latter might be the "cost-based approach."

As this statement will show, the grant of price-cap flexibility and selective deregulation under the market-based approach raises substantial risks for competition and consumer benefit. Especially in an environment where the LECs will become direct rivals to their customers in the interexchange market, this approach will have adverse effects on consumers and efficient entrants, result in diminished rather than enhanced market competition, and even, paradoxically, create the need for greater regulatory oversight. The cost-based approach, by contrast, would create immediate benefits for consumers, encourage efficient entry, and promote the development of viable competition to regulate the market.

This statement explains these issues. It first notes some inherent limitations of the price cap mechanism for the evolution of competition. These were well understood when I was Special Assistant to the Chief of the Common Carrier Bureau of the FCC with

major responsibility for the design of price caps for AT&T and, later and to a more modest degree, for the LECs. Next it discusses various provisions of the market-based approach proposed in this proceeding that raise special concerns for competition. Finally, it offers some observations about the cost-based alternative approach and the transition to competition in the access market.

PRICE CAPS ARE NOT A PANACEA

Price caps are one of the truly novel and practicable regulatory innovations of recent times. In numerous industries and countries, price caps have been adopted in preference to traditional mechanisms for public oversight. The reasons for this preference are usually stated in the following terms: Price caps encourage cost efficiency and product innovation. Price caps result in efficient (second-best) prices. Price caps blunt incentives for cross-subsidization among services. Price caps are easier to administer.

Although there is truth to each of these claims, a full accounting must recognize several limitations to price caps. First, a number of these propositions are based on assumptions that may not hold in actual practice. Second, there are other possible objectives to regulatory oversight, objectives not necessarily served by price caps. Moreover, in actual practice plans that are termed "price caps" often are various forms of incentive regulation with effects that are by no means necessarily identical to those under true price caps. Each of these limitations deserves attention.

Limitations of Price Caps in General

Since cost efficiency is the primary motivation for most price cap plans, it is useful to note at the outset that the desirable efficiency properties emerge unambiguously only under specific conditions. Notable among these are myopic profit maximization by the firm and credible commitment to nonintervention by the regulator. If the regulated firm adopts an intertemporal view as opposed to single-period profit-maximization, it may choose some degree of cost inefficiency today in order to secure a more profitable capped price in the future.[2]

Similarly, to the extent that the regulator resets the cap with any attention to the firm's past earnings performance (and it might do so for good reason), the regulated firm may no longer pursue strict cost minimization. Rather, it may engage in a variety of familiar anticompetitive actions such as cross-subsidization.[3] Much attention has been devoted to designing actual plans that minimize the risks of strategic behavior by the regulated firm and also the adverse impact of regulatory intervention.[4]

Moreover, there is nothing in the pure structure of price cap plans that encourages the provision of optimal service quality. A truly fixed price actually provides an

---

2 D. Sappington, "Strategic Firm Behavior Under Dynamic Regulatory Adjustment Process," *Bell Journal of Economics*, 1980.

3 R. Schmalensee, "Good Regulatory Regimes," *Rand Journal of Economics*, 1989. D. Sappington and D. Weisman, *Designing Incentive Regulation for the Telecommunications Industry*, MIT Press, 1996.

4 I. Vogelsang, "Price Cap Regulation of Telecommunications: A Long Run Approach," in M. Crew, ed., *Deregulation and Diversification of Utilities*, 1989.

incentive to *reduce* quality to the extent that the resulting cost savings and profit gains outweigh any adverse demand effects.[5] This incentive is even stronger than under rate-of-return regulation, which does not allow the firm to retain the profit gain. One approach to this problem is to integrate quality standards into the formal cap (as has been done with Oftel's regulation of BT), although this is cumbersome and creates trade-offs with other objectives. More often the task of ensuring quality falls to the regulatory administration through the use of quality reporting requirements.

A further problem concerns pricing structure. Convergence to second-best pricing is not assured if demands for various services within the cap grow at very different rates and if (as is generally the case) lagged service quantities are used as weights for the price cap. Prior knowledge of demand growth patterns allows the firm to manipulate such a cap to its advantage and thereby to continue to earn above-normal profitability. Here, too, there are possible design solutions, although each modification of the basic plan adds complexity and may sacrifice other benefits.[6]

None of these issues should be taken to imply that price caps do not have advantages, even compelling advantages. Rather, they are reminders that even in principle price caps are not panaceas, and that in reality many so-called "price cap" plans involve significant compromises.

---

5 J. Kwoka, "Implementing Price Caps in Telecommunications," *Journal of Policy Analysis and Management*, 1993.

6 T. Brennan, "Regulating by Capping Prices," *Journal of Regulatory Economics*, 1989. I. Vogelsang, "Optional Two-part Tariffs Constrained by Price Caps," *Economics Letters*, 1990.

Limitations Specific to a Dominant Firm Facing Rivals or Entrants

The above concerns all apply to the case of a pure monopoly subject to price caps as well as to a dominant firm confronting small rivals or new entrants. In the latter case, however, a further and distinct set of issues arises. Since this case is far more common than pure monopoly and since it better describes the circumstance emerging for the LECs, these particular issues bear close examination.

To begin, it should be noted that nothing in price caps in any way alters the firm's incentives to maximize its private profitability. To the degree that the social objectives of cost minimization, product innovation, and cost-based pricing contribute to its profits, those will occur as by-products of the firm's chosen strategy. But the firm has no interest in these objectives for their social value, and so whenever they conflict with its profitability those objectives will not be realized. This fact emphasizes the critical difference between price caps and rate-of-return regulation: It is not that firm objectives have changed. Rather, there is greater--but still imperfect--compatibility between private incentives and social objectives.

The discrepancy between private and social objectives is most apparent when the price capped firm faces a new competitor or a small rival. Whereas society has a compelling interest in the competition that entrants and rivals bring, the dominant firm's profit incentive gives it every reason to handicap entry and expansion by rivals. Price caps do not alter these incentives and do not prevent anticompetitive behavior. For example, the incumbent can mount a defense of its existing markets by selectively and strategically lowering price so as to render such entry unprofitable. The resulting profit

sacrifice can be offset by price, revenue, and profit increases in other markets that were previously constrained by the same cap. Ironically, therefore, the very price and profit constraint imposed by caps forms the basis for recovery of the costs of anticompetitive actions in particular targeted markets.

In some important respects, price caps may actually *enhance* the ability of a dominant incumbent to deter entry and handicap rivals. The decoupling of price from cost and the unilateral ability to alter price gives the firm enormous discretion over individual prices--greater than that of a traditionally regulated firm, and perhaps more akin to an unregulated firm. For a dominant incumbent, this discretion will result in predictably anticompetitive actions.

In the further case where a monopoly firm supplies services needed by its actual or potential rivals in a related market, this discretion will be used to disadvantage such rivals and sabotage the emergence of viable competition. The price-capped monopolist can do this by raising the price or lowering the quality of the necessary service supplied to its rivals. There is absolutely nothing in the pure theory of price caps that prevents such conduct (which is, of course, precisely why the Commission held expanded interconnection tariffs outside of caps). And as is well understood, raising rivals' input costs or degrading input quality can cripple those rivals and even force them out of the market.

Such strategic pricing can deter entry by equally efficient and even more efficient rivals than the incumbent firm, not just by relatively less efficient rivals that would not survive in competitive equilibrium. This possibility arises since the simultaneous

recovery of foregone revenues and profits fundamentally alters the firm's calculus determining the rationality of such behavior. That is, in contrast to conventional predation scenarios, the firm does not have to wait until some uncertain future period to begin recouping its costs of anticompetitive actions. It should also be emphasized that concern over such strategic pricing rises with the *degree* of pricing flexibility granted under price caps.

Finally, price caps may also result in a greater degree of unpredictability to prices, with potentially adverse effects on consumers and competitors alike. Since prices are no longer tied to costs or any other benchmark, the dominant firm may set and change prices for any reason it chooses. Thus, the company's perceptions (whether accurate or not) of changing market conditions, the effects of new services offered by the company itself, the effects of related services perhaps offered by other companies, as well as strategic behavior by the company itself all may prompt price movements that are difficult for outsiders to anticipate.

This unpredictability may be disruptive to consumers seeking nothing more than simple low-cost service and to competitors and new entrants striving to make rational investment decisions. To the extent that the price-capped firm understands the advantage it gains from such unpredictable price movements, it may undertake them specifically for that reason. These strategic disruptions represent real costs to economic society, impeding rational consumer choice and the development of viable competition.

Baskets, Bands, and Cost-Based Prices

Theoretical price caps generally assumes extremely broad coverage of services and perfectly flexible pricing. In practice, however, conduct such as just described can be prevented only by extraordinary regulatory vigilance on a case-by-case basis or by some ancillary restraints on the pricing conduct of the dominant firm.[7] To avoid costly and cumbersome administrative processes, the latter are to be preferred wherever possible. Appropriate ancillary constraints under price caps include baskets and bands.

The intent of bands--limits on the annual price changes for individual services--is twofold: First, the ceiling feature of bands prevents rapid and excessive price increases that might otherwise impose considerable transition costs upon consumers. While the ceiling does not preclude eventual attainment of almost any price, the rate of change is moderated. Second, the floor portion of bands prevents large price decreases targeted at small rivals or new entrants. Again, while price may be lowered over time, floors control the large and swift changes characteristic of strategic pricing. In both respects, bands may be seen as policy responses to the concerns outlined earlier.

The intent of baskets--subsets of services subject to a distinct cap--is also twofold; First, combining cross-elastic services or services bought by common customers minimizes the consequences of price changes facing any customer class. The impact of a price increase on one service may be at least partially offset by the customer switching to

---

7 I. Vogelsang and J. Finsinger, "A Regulatory Adjustment Process for Optimal Pricing by Multiproduct Monopoly Firms," *Bell Journal of Economics*, 1979. Kwoka, "Implementing Price Caps in Telecommunications."

substitute services whose price may not rise, or it may be offset by a necessary decline in the prices of other services faced by the same consumer. Second, combining services facing similar degrees of competition reduces the ability of the dominant firm to trade off selective price decreases on services where it faces competition against price increases on continued-monopoly services. This, too, helps prevent strategic pricing to deter efficient entry.

These restraints are intended to adapt theoretically pure price caps to the reality of markets where customers count, where the firm faces competitors, or where the firm's competitors may also be its customers. Without them the operation of price caps could readily be distorted from its objectives of efficient prices and competition. As a consequence, baskets and bands exist in virtually all real-world price cap plans.

MARKET-BASED VS. COST-BASED ACCESS REFORM

The Notice proposes two alternative approaches toward competition in the market for access services--market-based and cost-based ("prescriptive"). The market-based approach consists of two phases, each defined by a set of competitive criteria and in turn triggering specific regulatory relaxation. Cost-based reform would move access prices more quickly to levels based on cost and then allow viable competition to emerge. These two approaches differ in numerous important ways.

The Alternative Approaches

Perhaps the most important conceptual difference between the market-based and cost-based approaches is that their time intervals and final outcomes will be different. Undiminished incentives to maximize profits will always cause the LEC to manipulate price caps to its advantage by impeding entry and competition. Selective price cutting, discriminatory provision of access, delays in offering unbundled network elements in ways that best allow for competitive access provision, delays in any new offerings until the LECs' own competitive alternatives are ready to be offered--the risks of all of these strategies will actually be enhanced under market-based reforms.

For these reasons, the Notice's assertion that the market-based approach "creates incentives for incumbent LECs to act quickly to open up the local exchange and exchange access market to competition" (para. 142) seems more hopeful than realistic. The LECs simply have no such incentives--not inherently, not under price caps generally, and not as a result of the market-based approach--the possible effect of Section 271 of the Telecommunications Act notwithstanding. Indeed, this proposition would seem to require the unlikely circumstance that LEC profits under access market competition exceed those under continued monopoly.

Furthermore, the final outcome of the market-based and cost-based approaches would probably differ significantly. As already noted, market-based reforms provide additional means for the LECs to forestall entry, thereby diminishing competition. But even if the market-based approach results in a number of new competitors, the LECs' enhanced pricing flexibility would allow them to distort the entry process. They could

deter certain entrants and perhaps accommodate others that are less likely to pose as serious a competitive constraint. They could alter the mix of possible service offerings to ensure they do not lose customers unnecessarily. And nothing ensures that access price would resemble underlying cost--and most certainly not for all services, customers, and regions.

The Notice asserts as a virtue of the market-based approach that it "allows marketplace forces, rather than regulation, to determine how quickly prices move to cost-based levels" (para. 142). The reality, however, is that the "marketplace forces" making this determination may be nothing more than continued LEC market power. Reliance upon the LECs to determine the relationship of price to cost will not set the stage for viable entry and competition.

For all these reasons, the market-based approach is likely to preserve continued market power for the LECs. It is likely to require continued regulatory oversight of various unresolved matters and perhaps of newly contentious interactions between the LECs and their customers-competitors. Prospective entrants into local access provision will face enhanced difficulties, as will existing interexchange carriers. The market-based approach represents, in short, what may be termed "premature deregulation"--allowing largely unregulated conduct by an incumbent monopolist that does not yet face competition that sufficiently constrains its market power.

By contrast, the cost-based approach offers compelling advantages under these circumstances. It prevents the incumbent monopolist from utilizing its market power to further harm consumers. It precludes selective price increases to take advantage of low

market demand elasticities or the absence of competitive alternatives. It would generate immediate consumer benefits as prices fall for those services and markets where they previously were fixed well above underlying costs.

Further benefits of cost-based pricing emerge on the competition side. Such a standard would effectively prevent the kind of targeted, strategic pricing described above. Strategic pricing can sabotage entry and thereby slow and distort the process by which viable competition emerges. That in turn postpones the day when competition can be relied upon to replace regulation as the constraining force on the incumbent firm.

In addition, with prices at cost, the entry that does occur will be "efficient." That is, these will be cost-competitive firms, fully capable of surviving in the long run in the market. Allowing prices to exceed cost creates artificial incentives for entry and inevitably results in inefficient entrants without real prospects for long-term survival. Inefficient entry entails excess costs in the short run and is misleading about the prospects for true competition in the long run.

While the cost-based approach would require some initial cost determinations, these would not be unprecedented (e.g., Commission reliance upon forward-looking costs in the interconnection order). Furthermore, these cost determinations would not have to be repeated each year. Instead, price caps could govern annual price changes using the usual overall cost factors plus baskets and bands. Since the initialization would ensure the correspondence of price and cost, the subsequent flexibility provided by price caps could provide a balance between the firm's need for pricing discretion and consumers' and competitors' interests in fostering competition.

"Substantial Competition" and Deregulation

Regardless of the choice of approach, the Notice proposes essentially to deregulate services that face "substantial competition" (para. 150). The proposed criteria for substantial competition are the same as those employed in price caps for AT&T: demand responsiveness, which captures the ability of a firm to raise price without excessive fall-off of customers; supply responsiveness, to measure the ability of other suppliers to move into the market in response to a price rise; market share, which may signify market power; and past pricing below the cap, a possible indicator that competition is replacing regulation as the decisive restraining force in the market.

Both this standard and the associated criteria are subject to certain reservations. Perhaps most fundamentally, "substantial competition" is nowhere defined in the Notice and therefore would likely be defined by the criteria themselves. But that approach is perfectly circular. It provides no basis for judging the adequacy of either the standard *or* the criteria. Consequently, the following alternative approach is suggested:

(1) Deregulation should be deemed appropriate only at the point that competitive forces can and predictably will constrain a firm with market power as well as regulation itself. That is, the competitive forces must in actual fact be similarly constraining over anticompetitive behavior, such as excessive prices that injure customers, strategic pricing and related conduct that inhibits competition, and undue discrimination. "Some" or even perhaps a "substantial" degree of competition will not suffice if it is unable or predictably unwilling to act in a constraining manner.

(2) As the basis of comparison, the regulation alternative should not be construed as some idealized form of regulation. On the other hand, it should also not simply be the regulatory regime that happens to be in place if that regime has some clear defect. Rather, the benchmark should be some practical and reasonably effective mechanism of oversight and control, with due regard for the risks of deregulation as well as the costs of regulation.

(3) Practical indicia of constraining competition may include the variables enumerated in the Notice, with appropriate provisos. The following provisos and issues are noted:

- Demand responsiveness must be interpreted in light of relative prices, not simply potential substitutability in use by customers. That is, enumerating alternative services that are technologically equivalent does not help measure actual demand elasticity.
- Demand responsiveness must recognize possible fixed costs of switching services or suppliers, in addition to usage costs on an on-going basis. The fixed cost may be hardware, software, or knowledge skills which would be incurred by switching.
- Even if demand responsiveness is substantial in the long run, it may be inadequate in some short or medium run. As one indicator of run length, it might be noted that the Justice Department Merger Guidelines are concerned with firms' ability to raise price for as little as one year.

- Supply responsiveness over the short-run and long-run must be distinguished. Short-run supply response is determined by cost curves, in turn the result of technology and capacity. Long-run response depends upon entry conditions, a function of technological, strategic, and regulatory factors.
- Supply responsiveness may be adequate in the short run but not the long, the long run but not the short, neither, or both. Each of these possibilities raises different competitive issues. For example, temporary excess capacity may result in substantial short-run responsiveness without necessarily implying similar or any long-run responsiveness and competitive constraint.
- Market share conveys some information about market power and competitive constraints, but the actual degree of market power may not be measured directly by share. Market power is smaller if demand and supply responsiveness is great and larger to the degree that they are low. The chosen conduct of the leading firm also affects interpretation of any given share, for example, if it behaves as a textbook declining dominant firm.
- The pricing of services under price caps would seem to provide potentially valuable information about competitive forces. As the Notice cautions (para. 159), however, this signal is subject to manipulation by the dominant firm seeking deregulation and hence its informational value must be discounted.
- Unbundled network elements may in time represent an important competitive constraint, but the Notice places enormous reliance upon untested and indeed nonexistent devices. The UNE "card" is played repeatedly to resolve a

lengthy list of competitive concerns (e.g., paras. 148, 150, and 157). This is even as the Notice itself elsewhere observes a number of unresolved issues about the equivalence of UNEs and access service (para. 225).

A potentially overriding concern with application of these criteria to the LECs is the validity of the assumed analogy with price caps for AT&T. The Notice raises this issue but then immediately concludes (para. 150):

> In view of the similarities between the structure of and purposes behind the AT&T and the LEC price cap plans, the analytical framework that we used to streamline AT&T's services would appear to be an appropriate method for effectively deregulating incumbent LEC services.

But similarities in the structure and purposes of regulation are irrelevant to the criteria for *deregulation* if underlying conditions differ. And in the present case the circumstances faced by AT&T and the LECs differ considerably. The most important difference (noted in passing in the Notice) is the continued control by the LECs over bottleneck facilities. LECs' control over the local exchange--which is certain to persist in most places for a considerable period of time and in some places indefinitely--conditions all their conduct. The LECs are both determined to defend their monopoly in that market and to utilize that market power to gain advantage elsewhere.

In light of this, the question is whether the same criteria for competition and deregulation are equally applicable to the LECs as to a company with no such control (e.g., AT&T). For at least two reasons this would not appear to be the case. First, the economic model of a dominant firm--presumably that used as a framework for developing criteria for competition--does not contemplate a multiproduct dominant firm

that is both a supplier to and competitor of the same other firms. The further degree of freedom possessed by LECs in such circumstances inevitably affects their decisions and calls into question the implications of any simple model that fails to reflect this fact.

Second, the economic costs of premature deregulation are far greater in the case of the LECs than for a company without bottleneck control of any service. As noted earlier, bottleneck control threatens the efficient operation of all markets simultaneously--not just the local exchange, but also the access market and the interexchange market. The potential adverse effects of excessive pricing flexibility and premature deregulation are magnified by the multiplicity of such related markets, as discussed below.

The Market-Based Approach

These various concerns can be illustrated directly with the specific proposals for regulatory reform that comprise the market-based approach. That process involves two phases, each with its own sets of triggers followed by regulatory relaxation. Phase I is triggered by eight conditions defining "potential competition," after which the LEC can geographically deaverage, offer volume and term discounts, provide contract tariffs and individual RFPs, and introduce new access services. Phase II or "actual competitive presence" is defined by three conditions. Thereupon, service categories within baskets would be eliminated, access could be priced differentially among customers, mandatory rate structure rules for transport and local switching would be ended, and the traffic-sensitive and trunking baskets would be combined.

A threshold problem with the market-based approach described in the Notice is that it lacks a coherent theory relating the triggers or sets of triggers to the specific regulatory relief proposed. That is, of the actions proposed in each of the two phases, few if any derive specifically from the respective triggers for Phase I or for Phase II. Additionally, little rationale is provided for the particular combinations of triggers that define each phase or for the particular combinations of regulatory actions that result. Absent a theory of causation, the very framework of the process is unconvincing and the logic of its numerous particulars is wanting.

In addition, the Notice appears more determined to grant the LECs pricing flexibility and outright deregulation than to address the predictable costs and risks of such actions. For example, the discussion of geographic deaveraging emphasizes the merits of moving from the present highly averaged system. While cost-based access prices clearly represent the correct goal for policy, the proposed market-based reforms do not truly achieve that objective, and what they will produce raises serious concerns. The essential problem is that the proposal would allow the LECs to lower access charges *selectively*, which means in markets where they face actual or imminent competition. This will handicap entrants and rivals there, without jeopardizing LEC profits elsewhere--and may even induce the LECs to raise charges in other markets.

This is not to argue that prices in the former markets should remain high. Rather, the issue is that, if left to LEC discretion, price flexibility will predictably result in reductions designed primarily to deter competition. The LECs have no interest in bringing access prices systematically into alignment with costs or in benefitting

customers except to the extent and for the time period required to deter entry and competition. Thus, as proposed, geographic deaveraging will slow and distort actual competition in some markets and not benefit consumers in other markets at all.

Volume and term discounts raise analogous concerns, although with some distinctive features. Here, too, the goal of allowing the LECs to respond to competitive forces and the possibility that this will bring price into closer correspondence with costs have great appeal. There are, however, significant risks associated with such discounts. For one, the Notice contemplates granting the LECs the ability to give volume and term discounts without the need for any cost showing (para. 191), although it invites comment on this issue. The ability to price without regard to cost raises well-known risks of strategic behavior.[8]

As with deaveraging, volume and term discounts explicitly allow selective price reductions to forestall competition, rather than to foster it. Such discounts do not confer any benefit to customers in other markets and circumstances. In fact, to the extent that they are offered to some customers but not others, these discounts may simply be a form of price discrimination, with very ambiguous overall welfare effects.[9]

Term discounts represent a tool with which the LECs can lock in customers (Notice, para. 190) and prevent even efficient entrants from securing an adequate

---

[8] R. Noll and B. Owen, "The Anticompetitive Uses of Regulation: *United States v. AT&T*," in J. Kwoka and L. White, *The Antitrust Revolution*, HarperCollins, 1994.

[9] D. Carlton and J. Perloff, *Modern Industrial Organization*, HarperCollins, 1994.

customer base. Given their position as monopoly incumbents, the risks associated with term discounts would seem clear. Interestingly, the Notice does agree that analogous risks predominate in the case of "growth" discounts (para. 192), at least in Phase I, but the same competitive concerns arise more generally.

Similar comments may be directed at the proposals for contract tariff and individual RFP responses. Again, the key issue is whether this grant of price flexibility to the LECs will, on balance, be used in ways that benefit competition and consumers, or whether it will actually forestall those benefits. Protections such as the requirement that there be "constraining competition" should be imposed to prevent the use of contract tariffs strictly for entry deterring or predatory purposes.

The further requirement that the tariff must be "generally available to similarly situated customers under substantially similar circumstances" (Notice, para. 194) is intended to fulfill the letter of the nondiscrimination rule, but in fact such language will not succeed in preventing de facto discrimination. Tariffs are easily constructed so that only one user is positioned to adopt them, even if ostensibly offered to all. An operative nondiscrimination rule would have to be framed more in terms of "general marketability" rather than "general availability," where the former standard would be met if some number (perhaps three) of bona fide, independent, and significant customers actually contract for such a tariff. At that point, it could be offered.

The fourth proposed reform in Phase I would deregulate new services. The rationale for this proposal is that unbundled network elements and mandated continued provision of "core" access services should provide adequate protection to consumers. As

noted earlier, however, UNEs are untested and their likely adequacy is subject to much controversy.

In addition, continued provision of "core" services does not prevent strategic manipulation of price cap provisions to the disadvantage of consumers. For example, the firm could offer outside the cap a scarcely different "new" service at a price that attracts most customers from the original capped service. This would result in a very low demand weight on the latter, so that its price might thereafter be increased without much adverse effect on other capped prices. That, in turn, would allow the price of the unregulated service outside the cap to increase to near-monopoly levels.

Such concerns led to great caution with respect to new services in the AT&T Order, and its lessons imply the need for at least the same degree of caution for the more-dominant LECs. New services should not be deregulated, except perhaps in the case where they are sufficiently distinct from all services within the cap. A "sufficient distinction" could be indicated by low cross-elasticity between the new service and any capped service, although the prospective nature of new services makes this criterion difficult to apply. Other operational criteria would need to be developed.

These concerns about increased flexibility do not constitute a reason for preferring current prices or pricing standards. Those have outlived their usefulness and now represent an impediment to consumer benefit and to competition. Rather, the critical issue is the need to structure a transition that recognizes the distinctive features of local access markets. Enduring LEC market power as well as the prospect of LECs as

competitors to their current customers alter the usual economic arguments for pricing flexibility and deregulation.

CONCLUSIONS

In this proceeding the Commission will define the process by which local access markets will evolve towards some competitive norm. The alternative approaches to this process outlined in the Notice reflect differing views not so much about the ultimate objectives nor about the specific issues that inevitably will have to be resolved. Rather, the approaches reflect different opinions about who should manage the process of reform.

The so-called market-based approach would confer on incumbent LECs themselves enormous discretion over the levers of market reform--overall pricing and terms of access, uniform vs. deaveraged prices, contract prices and other packaged tariffs, etc. It implies a great trust that LEC conduct will ultimately serve social objectives. The path the Commission chooses to call "prescriptive" is premised on the view that the public interest will be better served by requiring certain normative standards--specifically, cost-based prices--be met from the outset. Thereafter efficient competition would be allowed to emerge.

As detailed in this Statement, the market-based approach does not adequately reflect the unambiguous risks of that approach. Broad and flexible price caps and outright deregulation have predictably adverse consequences in markets with monopoly power, dominant incumbents, and overlapping supplier-customer relationships. In the

case of local access markets, these consequences will jeopardize the very purposes of reform.

By contrast the prescriptive or cost-based approach avoids these pitfalls by the simple expedient of mandating socially efficient, cost-based pricing. Such a rule would effectively avoid monopoly pricing, strategic entry-deterring pricing, and discriminatory pricing, and would itself be replaced as soon as sufficiently constraining competition emerged. Appropriately applied, this approach will better achieve cost efficiency, consumer benefits, and the emergence of efficient and viable competition in local access markets.